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### An Arkansas Practitioner's Guide to Perfecting Security Interests in Securities, Brokerage Accounts, and Other Forms of Investment Property under Revised Article 8 and Amended Article 9

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AN ARKANSAS PRACTITIONER'S GUIDE TO PERFECTING  
SECURITY INTERESTS IN SECURITIES, BROKERAGE ACCOUNTS,  
AND OTHER FORMS OF INVESTMENT PROPERTY UNDER  
REVISED ARTICLE 8 AND AMENDED ARTICLE 9

Everette L. Martin\*

On February 24, 1995, Arkansas became the first state in the nation to adopt the 1994 Revised Article 8 promulgated by the American Law Institute (ALI) and the National Conference of Commissioners on Uniform State Laws (NCCUSL).<sup>1</sup> The impetus for revising Article 8 of the Uniform Commercial Code ("U.C.C.") grew out of the need to tailor a set of intelligible legal rules to govern contemporary securities holding practices. Revised Article 8 is a seismic shift from the prior version's contorted distinctions between certificated and uncertificated securities toward a more pragmatic distinction between the direct and indirect holding of securities.<sup>2</sup>

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1. Jim Guy Tucker, Governor of Arkansas, signed House Bill 1038, Act 425 (1995), which repealed the prior version of Article 8 and adopted, with only minor, non-substantive changes, the Official Text of the 1994 Revision of Article 8 and made conforming changes to Articles 1, 4, 5, 9, and 10 (hereinafter collectively referred to as "Revised Article 8"). Act 425 became effective on July 28, 1995 and is codified at ARK. CODE ANN. §§ 4-8-101 to -603 (Michie Supp. 1995). Unless otherwise noted, particular provisions of Revised Article 8 and Amended Article 9 will be referenced by the corresponding Arkansas Code Annotated section.

In addition to Arkansas, Revised Article 8 has been adopted in Arizona, Idaho, Illinois, Indiana, Louisiana, Minnesota, Nebraska, Oklahoma, Oregon, Texas, Washington, and West Virginia. See ARIZ. REV. STAT. ANN. §§ 47-8101 to -8511 (Supp. 1995); IDAHO CODE §§ 28-8-101 to -511 (1995); 1995 Ill. Laws 364; IND. CODE ANN. §§ 26-1-8.1-101 to -511 (Burns Supp. 1995); LA. REV. STAT. ANN. §§ 8-101 to -511 (West Supp. 1996); MINN. STAT. ANN. §§ 336.8-101 to -603 (West Supp. 1996); NEB. REV. STAT. §§ 8-101 to -603 (1995); OKLA. STAT. ANN. tit. 12A, §§ 8-101 to -603 (West Supp. 1996); TEX. BUS. & COM. CODE ANN. §§ 8.101-511 (West Supp. 1996); WASH. REV. CODE ANN. §§ 62A.8-101 to -601 (West Supp. 1996); and W. VA. CODE §§ 46-8-101 to -601 (Supp. 1995).

2. The terms direct and indirect holding of securities are used to describe a shareholder's relationship with the issuer of a security. The term *direct* holding is used when the shareholder has a direct relationship with the issuer, and the term *indirect* holding is used when the shareholder holds the security in what is commonly referred to as its "street name." That is, the shareholder does not have a certificate but rather an account with a broker, who in turn has a direct relationship with the issuer. (See Figure 1 *infra*.) For a general discussion of the direct and indirect holding systems, see Uniform Commercial Code, 2C U.L.A. 39-41, Prefatory Note §§ C-D (Supp. 1996). See also Charles W. Mooney, Jr., et al., *An Introduction to the Revised U.C.C., Article 8 and Review of Other Recent Developments with Investment Securities*, 49 BUS. LAW. 1891, 1893-95 (1994) (hereinafter Mooney, Jr., *An Introduction to the Revised U.C.C., Article 8*); James S. Rogers, *An Essay on Horseless Carriages and Paperless Negotiable Instruments: Some Lessons from the Article 8 Revision*, 31 IDAHO L. REV. 689, 691 (1995) (hereinafter Rogers, *Horseless Carriages*); James S. Rogers, *Behind the Article 8 Ball: The Law Plays Catch-up with Indirect Securities Holding*,

Revised Article 8 will have the most significant impact on those persons dealing with investment property<sup>3</sup> held indirectly, that is, in brokerage or other custodial accounts.

Some of the most significant changes to Revised Article 8 involve the new concepts developed by the drafters to describe the rights and responsibilities of participants in the indirect holding system. For example, Revised Article 8 uses the term "securities entitlement" to describe the rights and interests of a person holding a security or other financial asset through a third-party intermediary such as a broker, bank, or clearing corporation.<sup>4</sup> Revised Article 8 simplifies the rules regarding perfection of an account held by a securities intermediary by replacing the complicated rules of transfer with a simpler system based on "control."<sup>5</sup> Another welcome change is the clarification of the choice of law rules.<sup>6</sup> The revisions clarify the rights and obligations of the various participants of the indirect holding system, and their impact should, overall, be favorable and promote market stability. As with any statute, however, there are some subtle and not so subtle trade-offs. As will be explained, Revised Article 8 provides for a new system of priorities which, in an effort to balance the market-driven need for speed and certainty, may yield some surprising results for those who cannot or do not protect themselves by taking *control* of their investment property.<sup>7</sup>

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BUS. LAW. TODAY, Jan.-Feb. 1994, at 44-46; Jeanne L. Schroeder, *Is Article 8 Finally Ready This Time? The Radical Reform of Secured Lending on Wall Street*, 1994 COLUM. BUS. L. REV. 291, 308-32 (hereinafter Schroeder, *Article 8*).

3. The term *investment property* is a new general category of collateral and is broadly defined under Revised Article 8 to include securities, security entitlements, security accounts, commodity contracts, and commodity accounts. ARK. CODE ANN. § 4-9-115(1)(f) (Michie Supp. 1995). The conforming amendments to Article 9 specifically *exclude* "investment property" from the definition of goods, instruments, and general intangibles. *See id.* §§ 4-9-105(1)(h), 9-105(l)(i), and 9-106.

4. ARK. CODE ANN. § 4-8-102(17) (Michie Supp. 1995). Revised Article 8's inclusive scheme defines a "financial asset" as any property, including securities, which may be "held by a securities intermediary for another person in a securities account . . ." *Id.* § 4-8-102(9)(iii).

5. "Control" is simply the means by which a purchaser of securities "place[s] itself in a position where it can have the securities sold, without further action by the owner." U.C.C. § 8-106 cmt. 1 (1994). A given method of obtaining control will depend on the form of the security interest held and the identity of the person or entity holding that interest. *See* ARK. CODE ANN. § 4-8-106(a)-(e) (Michie Supp. 1995).

6. *See* ARK. CODE ANN. § 4-8-110 (Michie Supp. 1995).

7. Professor Schroeder calls this a "potentially troublesome aspect" which primarily impacts retail customers by designing a protection scheme around the new concept of "control" rather than retaining the age old bona fide purchaser prevails standard. Schroeder, *Article 8*, *supra* note 2, at 298-99. Although the new rules of Revised Article 8 may appear to reward unethical behavior, Schroeder maintains that the concept of "control" provides much needed stability to an area of commercial law which obfuscated the actual risks

## I. HISTORY

In order to fully appreciate why it was necessary to make wholesale revisions to the previous version of Article 8, it is helpful to have an understanding of Article 8's evolution.<sup>8</sup> The original version of Article 8 was premised on the physical delivery of paper stock certificates.<sup>9</sup> Each time the securities were traded, the physical certificates had to be transferred from the holder back to the issuer or transfer agent and then reissued in the name of the purchaser. Because the paper stock certificate was tangible evidence of the holder's rights, it made sense to apply traditional concepts of property law.<sup>10</sup>

This process was so labor intensive and slow that by the late 1960s, the stock market had to close one day a week simply to settle all of the trades.<sup>11</sup> Because the biggest delays were incurred in actually physically trading the certificates, the logical solution (or so the drafters thought) was to do away with the paper certificates and simply have each issuer register the shareholders on their books. Thus, a revision effort commenced with its stated aim to develop a set of laws governing "uncertificated securities."<sup>12</sup> The 1977 Amendments to Article 8 focused on adding provisions dealing

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confronted by the investor. Schroeder, *Article 8*, *supra* note 2, at 299-300. For a more in-depth discussion of the new concept of control in Revised Article 8, see discussion *infra*, Part III.

8. See U.C.C. Series (Hawland) Special Release § 8-000:02 (1995).

9. In actuality, the U.C.C. provided four situations in which "delivery" was deemed to have occurred in the event the purchaser failed to receive the physical certificate; however, ownership was deemed to have passed because in each situation the security "[could] be identified as belonging to a specific purchaser." Martin J. Aronstein, *The New/Old Law of Securities Transfer: Calling a 'Spade' a 'Heart, Diamond, Club or the Like,'* 12 CARDOZO L. REV. 429, 430 (1990).

10. For a criticism of the continued use of principles embodied in property law to describe the rights and responsibilities derived from ownership of a security or security interest, see Schroeder, *Article 8*, *supra* note 2, at 303-08. See also generally Aronstein, *supra* note 9, at 430.

11. Schroeder, *Article 8*, *supra* note 2, at 310. Schroeder recounts the practice of the New York Stock Exchange of closing two hours early everyday and eventually all day on Wednesdays to complete paper work. Schroeder, *Article 8*, *supra* note 2, at 310. See also Egon Guttman, *Transfer of Securities: State and Federal Interaction*, 12 CARDOZO L. REV. 437, 437-38 (1990).

12. The conventional wisdom at the time was that the problems within the securities trading market resulted from too much paperwork, which could be reduced by the use of a certificateless security. However, the drafters only gave Article 8 a facelift rather than wholesale revision to reflect the true conditions of the marketplace. Conceptually, the drafters of Amended Article 8 merely changed the term "delivery" to "transfer" while the infirmities of Article 8 were exacerbated by applying the same troubled rules governing certificated securities to uncertificated securities. Schroeder, *Article 8*, *supra* note 2, at 312-15.

with uncertificated securities analogous to the provisions dealing with certificated securities.<sup>13</sup>

The 1978 revision can best be summarized by the phrase "too little, too late." Remember that the "paper crunch" occurred in the late 1960s while the 1977 Revision did not occur until a decade later. In the interim, the market responded to this problem by developing an indirect holding system for securities whereby "delivery" is accomplished by an entry on the books.<sup>14</sup> That is, a securities depository, such as Depository Trust Company ("DTC"), is used to hold the paper stock certificates on behalf of its members, who consist primarily of banks and large brokerage firms. The banks and brokerage firms, in turn, hold the securities on behalf of their customers.<sup>15</sup> The distinction between the direct and indirect holding system is illustrated in Figure 1. Both Dan Direct and Cede & Co. have a *direct* relationship with the issuer of the security, Leap of Faith Bungee Corporation ("LFBC"). That is, each has a paper stock certificate representing the number of shares of stock each has in LFBC. Accordingly, LFBC records also show that Dan Direct and Cede & Co. hold shares of stock. Dividends are sent to them directly and in order to sell the stock, each must physically deliver the paper certificate to the issuer.

The relationship between Big Bull Brokerage Firm ("BBB") and LFBC is *indirect*. That is, BBB does *not* have a paper stock certificate to evidence its shares of stock in LFBC. Instead, BBB's ownership interest is recorded on the books of the Depository Trust Company ("DTC"). Similarly, both the local brokerage firm and Customer #3 hold their shares of LFBC stock indirectly.

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13. Actually, the responsibility of the 1977 Drafting Committee rested solely with creating a scheme for the transfer of uncertificated securities while leaving the rules on certificated securities intact. Uniform Commercial Code, 2C U.L.A. 39, Prefatory Note (Supp. 1996).

14. Schroeder, *Article 8, supra* note 2, at 322-23 ("As a result Amended Article 8's proposed cure for the paper crunch—the uncertificated security—was rendered unnecessary before it was ever born.").

15. This book-entry trading system is easily understood by the following analogy: Think of possession of a certificated investment security as having \$100 in actual currency in your possession. Conversely, a book-entry security is similar to having \$100 located in a checking account at a financial institution. The \$100 in actual currency is controlled by possession, whereas the \$100 located in the checking account is controlled by the authorized signatory on the account. Ascertaining which clearing corporation holds the securities to be pledged and the identity of the broker holding the securities for the borrower is akin to determining at which bank the relevant checking account is located and the identity of the signatory on the account.

Susan E. Collins, et al., *How to Maintain Operational Control When Taking Marketable Securities as Collateral*, 9 COM. LENDING. REV. 4, 5-6 (1994).

The fact that the securities are held in one central place eliminates the need for participants to endorse, transfer, deliver and reissue large numbers of stock certificates back and forth. Instead, the brokerage firms and other intermediaries simply net out the number of shares transferred among their accounts during the day so that on the settlement date, a clearing corporation,<sup>16</sup> such as the National Securities Clearing Corporation, simply makes corresponding adjustments in each participant's account.<sup>17</sup> The ability to net out the trades on the books of the clearing corporations and intermediaries dramatically increases the number of trades which can be processed.<sup>18</sup>

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16. A clearing corporation is defined in Revised Article 8 as:

(i) a person that is registered as a "clearing agency" under the federal securities laws; (ii) a federal reserve bank; or (iii) any other person that provides clearance or settlement services with respect to financial assets that would require it to register as a clearing agency under the federal securities laws but for an exclusion or exemption from the registration requirement, if its activities as a clearing corporation, including promulgation of rules, are subject to regulation by a federal or state governmental authority.

ARK. CODE ANN. § 4-8-102(5) (Michie Supp. 1995).

17. Professor Mooney refers to the process as "clearing and settlement" and describes it in the following manner:

'Clearing and settlement' comprise the process that occurs after securities trades (agreements to sell and buy) are made. 'Clearing' is the process whereby the trades are compared, matched, and confirmed. 'Settlement' is the process whereby parties to trades fulfill their obligations thereunder—generally a "delivery" of the securities by the seller and payment of the agreed price by the buyer.

Charles W. Mooney, Jr., *Beyond Negotiability: A New Model for Transfer and Pledge of Interests in Securities Controlled by Intermediaries*, 12 CARDOZO L. REV. 305, 316-17 (1990) (hereinafter Mooney, Jr., *Beyond Negotiability*). Moreover, delivery is no longer understood in the physical sense but occurs the moment transfers are made on the books of the securities intermediaries. *Id.* at 317 n.20. For a description of two of the principal systems for clearing and settlement in the investment securities markets, see *id.* at 317-24, text and accompanying notes.

The "clearing and settlement" process, sometimes referred to as "netting," may be explained by the following example:

Suppose that customer A has an account with broker B. A orders B to sell 100 shares of XYZ corporation to customer C who has an account with broker D. B and D do not immediately transfer any identifiable shares of stock, but merely make note of the transaction. Later that same day, E, another customer of broker D, sells 100 shares of XYZ to F, a customer of broker B. After the market closes, B and D will then net out all trades of XYZ stock made between them on that date. A's trade with C, and E's trade with F will cancel each other out. As a consequence, B's books will show a transfer of 100 shares of XYZ . . . into F's account, but there will be no corresponding entries on B and D's books showing a transfer of an identifiable individual share of XYZ stock from B to D, or from D to B. The National Securities Clearing Corporation ("NSCC") performs these clearance and netting functions with respect to DTC participants.

Schroeder, *Article 8, supra* note 2, at 332.

18. According to statistics published daily by the Wall Street Journal, in the last six

This system is illustrated in Figures 1 and 2 in a grossly simplified form. In this example, Customer No. 1 wants to sell 50 shares of Leap of Faith Bungee Corporation ("LFBC"), Customer No. 2 wants to buy 200 shares of LFBC, and Customer Nos. 3 and 4 want to sell 50 and 100 shares of LFBC stock, respectively.<sup>19</sup> Each places an appropriate order to buy or sell with its intermediary firm as shown on Figure 2. On the settlement date,<sup>20</sup> the intermediaries merely adjust their books to show that Customer No. 2's account now holds 200 shares of LFBC stock, Customer No. 1's account has no LFBC stock, Customer No. 3's account has 100 shares of LFBC stock, and Customer No. 4's account has 150 shares of LFBC stock. Note that on the settlement date, appropriate entries are made with the DTC to reflect the change in positions among the Participant Bank, Big Brokerage Firm, and Huge Brokerage Firm; however, it was not necessary for the DTC to transfer the paper stock certificate or make any changes on the books of LFBC.<sup>21</sup>

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months the volume of trades on the New York Stock Exchange regularly exceeded 250 million shares per day. In fact, on December 15, 1995, 615 million shares were traded. By comparison, during the paper crunch of the 1960s, the decade observed a surge from an average of 3 million shares traded per day in 1960 to 13 million shares traded per day in 1968. Egon Guttman, *Transfer of Securities: State and Federal Interaction*, 12 CARDOZO L. REV. 437 (1990).

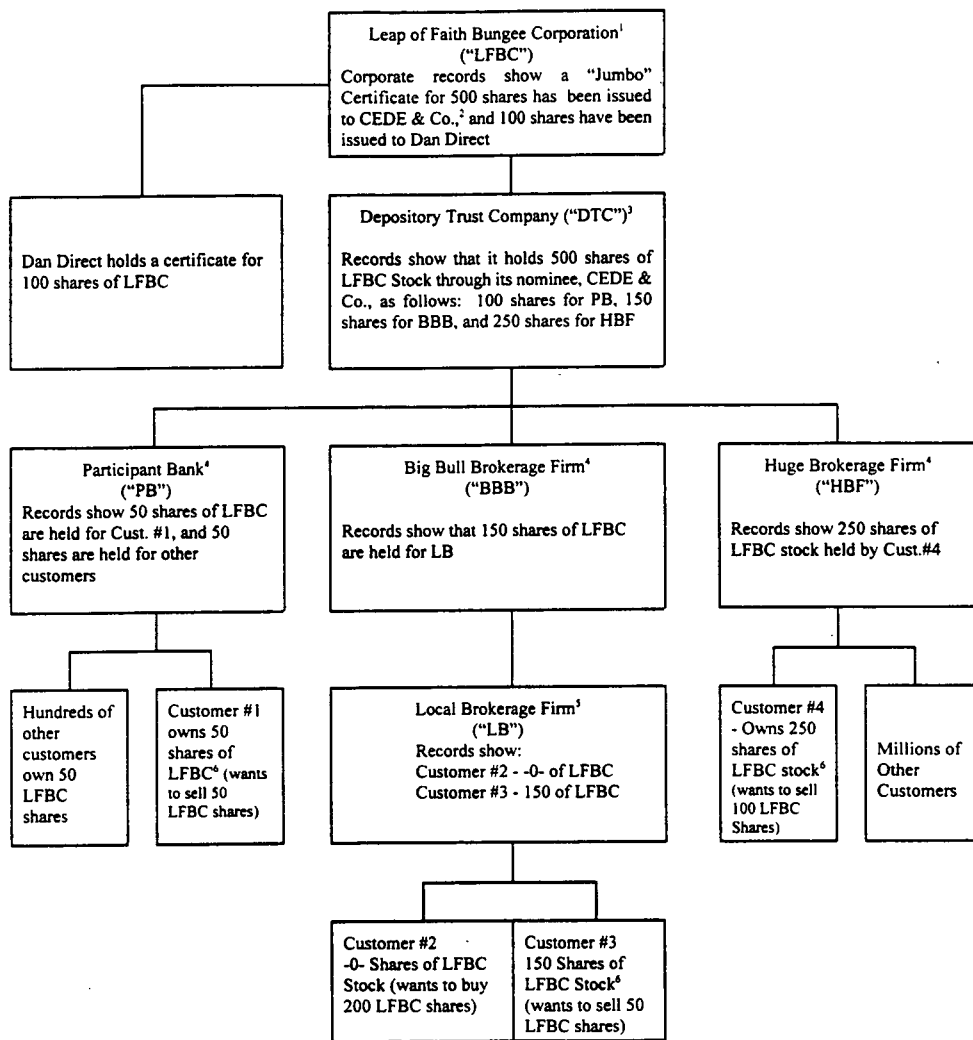
19. Note that none of these customers legally owns any shares of stock in LFBC, rather, each customer owns a "securities entitlement." The term "securities entitlement" is defined as the bundle of rights and property interest of a person who holds securities through a securities intermediary. ARK. CODE ANN. § 4-8-102(a)(17) (Michie Supp. 1995).

20. Settlement date should not be confused with trade date. While the trade date is the date on which the securities trade was made, the settlement date occurs three business days after the trade date when the purchaser is required to make payment to its securities intermediary, and the securities intermediary in turn receives "delivery" of the securities from the clearing corporation or other securities intermediary. Mooney, Jr., *Beyond Negotiability*, *supra* note 17, at 318 n.26. The drafters of Revised Article 8 consider the distinction between the trade and settlement date essential to understanding the limited scope of Article 8. For example, Article 8 defines the rights and duties of those individuals or entities involved in the transfer of property interests in securities, i.e. certain aspects of the *settlement* of securities transactions. On the other hand, the wealth of laws governing the securities markets, regulatory, contract, and corporate law, deal with contracts for the sale of securities, i.e. the execution of *trades* in securities. See Uniform Commercial Code, 2C U.L.A., Prefatory Note 45-46 (Supp. 1995).

The Securities Exchange Commission's rule requiring the payment for and delivery of securities no later than three business days after the "trade" is known as "T plus 3." 17 C.F.R. § 240.15c6-1 (1995). In addition, the Federal Reserve Board, which promulgates rules governing the extension of credit by and to brokers and dealers, provides for payment of a securities purchase under its regulations to occur no later than five days after the trade. 12 C.F.R. § 220.2(w) (1995).

21. DTC will hold the actual securities certificate while its records will reflect the change of positions among the participating intermediaries. The "registered" owner of the certificate is Cede & Co., a partnership used by DTC, although all legal rights with respect

**Figure 1 - Direct vs. Indirect Holding of Investment Property and the Clearing and Settlement Process. (Trading position at the beginning of the day.)**



<sup>1</sup> Referred to as the "Issuer" under Revised Article 8. See Ark. Code Ann. §4-8-201.

<sup>2</sup> CEDE & Co. is a partnership used by Depository Trust Company, as its nominee, to hold securities.

<sup>3</sup> Referred to as the "Clearing Corporation." See Ark. Code Ann. §4-8-102(5).

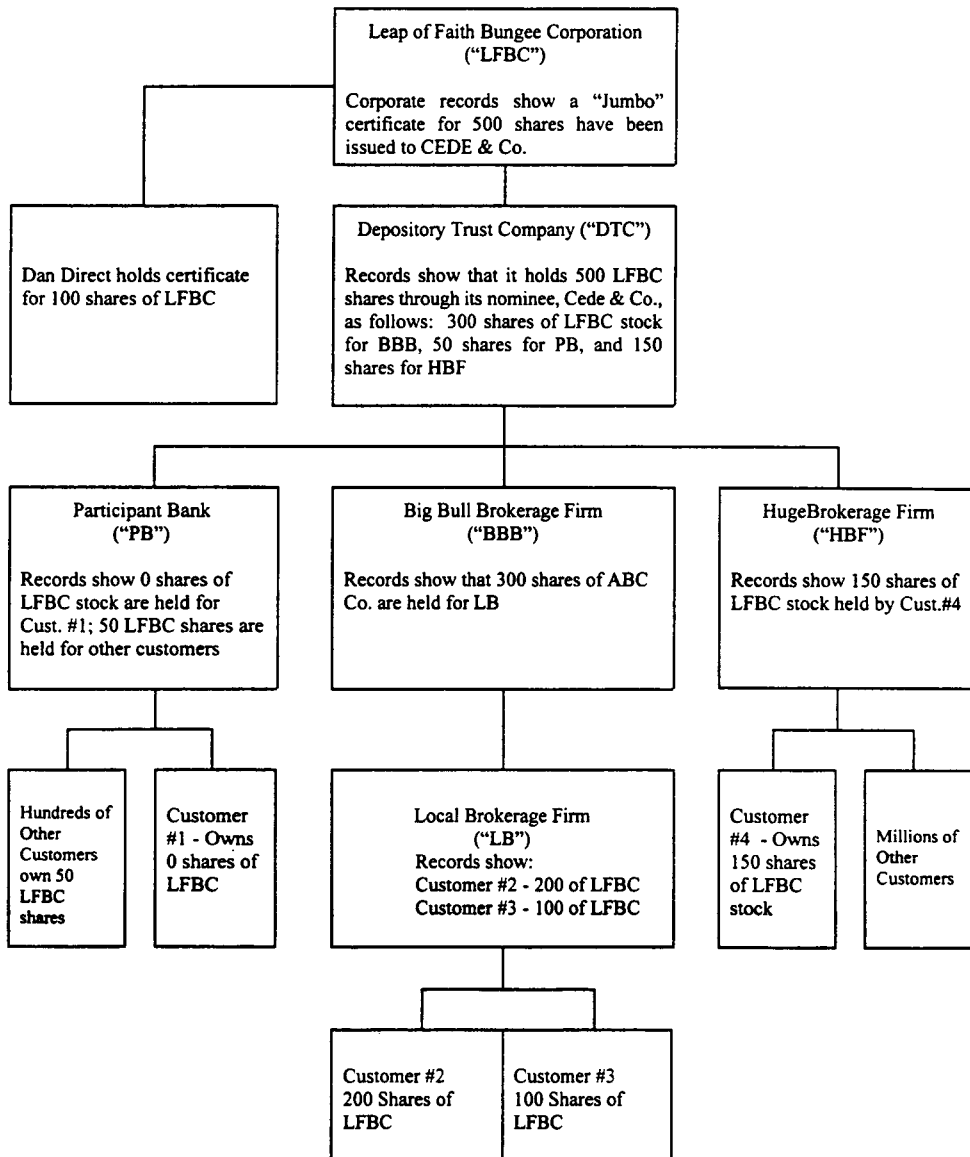
<sup>4</sup> PB, BBB and HBF are all classified as securities intermediaries because each maintains securities accounts for others as an ordinary part of their businesses. See Ark. Code Ann. §4-8-102(14).

<sup>5</sup> LB is also classified as a securities intermediary. *Id.*

<sup>6</sup> Called a securities entitlement. See Ark. Code Ann. §4-8-102(17).



Figure 2 - The Clearing and Settlement Process (Trading position after settlement.)



Recognizing the fundamental flaw in their prior attempts to revise Article 8, the drafters of the Revised Article 8 have attempted to take a neutral position on securities holding practices.<sup>22</sup> Thus, the rules governing the direct holding of securities remain substantially unchanged under the Revised Article 8.<sup>23</sup> The significant changes have been the adoption of rules for the indirect holding system by adding a new Part 5 to Article 8.<sup>24</sup>

## II. KEY TERMS AND CONCEPTS

As stated previously, the old terms and concepts of the previous versions of Articles 8 and 9 were inadequate to describe the *paperless* transactions within the indirect holding system. Consequently, the drafters were obliged to develop new terms and concepts which are best explained by dissecting a typical statement one receives from a brokerage firm, such as the one set forth in Figure 3. The term *securities entitlement* is used to describe Mr. Street's rights against Big Bull Brokerage and his property interest in the shares of stock and each of his other financial assets described in the portfolio position detail.<sup>25</sup>

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to the security are passed down to the actual customer. Schroeder, *Article 8, supra* note 2, at 324-25; see ARK. CODE ANN. §§ 4-8-505, -506 (Michie Supp. 1995). ARK. CODE ANN. § 4-8-505 places a duty on the securities intermediary to obtain any payment or distribution and to turn over the same to its customer. Similarly, ARK. CODE ANN. § 4-8-506 obligates the securities intermediary to either exercise various rights with respect to the investment security in accordance with the customer's orders or place the customer in a position to exercise the particular rights.

22. U.C.C. Series (Hawland) Special Release, Revised Article 8 Code Text & Official Comments, pt. 2, at 7-8 (1995). The drafters of Revised Article 8 followed a neutral approach whereby separate rules were developed to govern the direct and indirect holding system in an effort to provide certainty in the securities markets. *Id.* However, learning from the mistakes of the past, the aim of the revision process was to encourage market developments while limiting any unforeseen constraint on the evolutionary process of either holding system. *Id.*

23. U.C.C. Series (Hawland) Special Release, Revised Article 8 Code Text & Official Comments, pt. 2, at 9-10 (1995).

24. Of course, the rise of the indirect holding system should not be interpreted as sounding the death knell for paper certificates. There are still instances where paper certificates are needed. Of course, within the indirect holding system, paper certificates continue to be issued, but they are typically jumbo certificates representing thousands of shares and the certificates are immobilized in depositories and transferred by book entry. See *supra* notes 14-21 and accompanying text. Although most United States Treasury securities are issued in book entry form only, recently "mortgage-backed pass-through" securities guaranteed by the Government National Mortgage Association continued to clear and settle by way of physical delivery of paper certificates, although a new system of book entry transfers is emerging. Mooney, Jr., *Beyond Negotiability, supra* note 17 at 321 n.39.

25. ARK. CODE ANN. § 4-8-102(h)(17) (Michie Supp. 1995).

The Securities Account<sup>26</sup> describes the arrangement of all of the items in the Account Statement. In Figure 3, the account would cover all of the financial assets described in the position detail. Accounts are commonly identified by title of account *and* by account number.

The term securities intermediary is used to describe those who hold securities and other financial assets on behalf of others in the indirect holding system.<sup>27</sup> In Figure 3, the securities intermediary is Big Bull Brokerage. It should be noted, however, that the definition is rather expansive and also covers clearing corporations, brokers holding securities for customers, regional brokerage firms holding securities for brokerage firms, and banks acting as securities custodians.<sup>28</sup>

In Figure 3, Mr. Street is called the entitlement holder.<sup>29</sup> That is, Mr. Street is the person holding securities and other financial assets through a securities intermediary. It is possible to be both a securities intermediary *and* an entitlement holder. For example, in Figure 1, as between the Local Brokerage firm ("LB") and customers 2 and 3, LB is a securities intermediary, but as between LB and Big Bull Brokerage, LB is an entitlement holder.<sup>30</sup>

Although held in securities entitlement form, the 200 shares of LFBC stock are classified as securities.<sup>31</sup> The definition of a security has not

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26. A "securities account" under Revised Article 8 is:

an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset.

ARK. CODE ANN. § 4-8-501(a) (Michie Supp. 1995). Official Comment 1 notes that the following relationships clearly fall within the definition of a securities account: (1) between a clearing corporation and its participants; (2) between a broker and customers who leave their securities with the broker; and (3) between a bank acting as securities custodian and its customers. *Id.*

27. ARK. CODE ANN. § 4-8-102(a)(14) (Michie Supp. 1995).

28. *Id.*

29. "Entitlement holder" is the "person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary."

ARK. CODE ANN. § 4-8-102(a)(7) (Michie Supp. 1995).

30. See Comments, Hawkland, *supra* note 23, at 60.

31. Revised Article 8 broadly defines a security as:

an obligation of issuer or a share, participation, or other interest in an issuer or in property or an enterprise of an issuer: (i) which is represented by a security certificate in bearer or register form, or the transfer of which may be registered upon books maintained for that purpose by or on behalf of the issuer; (ii) which is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations; and (iii) which: (A) is, or is of a type, dealt in or traded on securities exchanges or securities markets; or (B) is a medium for investment and by its terms expressly provides that it is a security governed by this chapter.

Figure 3

**BIG BULL BROKERAGE<sup>1</sup> ACCOUNT STATEMENT**

Account Number <sup>2</sup>	Tax Identification Number	Period Covered
LR 627-533	635-46-3261	May 1 - May 31, 1996

**TITLE OF ACCOUNT****OFFICE SERVING ACCOUNT**

WALLY STREET<sup>3</sup>  
 No. 1 Emerald Drive  
 Little Rock, AR 72205

LITTLE ROCK, AR

PORTFOLIO POSITION DETAIL				
Category	Quantity	Name	Latest Price	Market Value
Stocks <sup>4</sup>	200 shares <sup>5</sup>	LFBC	\$28.00	\$4,000.00
U.S. Govt Money Markets <sup>4</sup>	1589 <sup>5</sup>	BB US Money Market	\$1.00	\$1,589.00
Bonds <sup>4</sup>	1,000 <sup>5</sup>	MNO Bonds	8-1/2	\$8,500.00

<sup>1</sup> Securities Intermediary. See U.C.C. §8-102(14).

<sup>2</sup> Securities Account. See U.C.C. §8-501(a).

<sup>3</sup> Entitlement Holder. See U.C.C. §8-102(7).

<sup>4</sup> Financial Assets. See U.C.C. §8-102(9).

<sup>5</sup> Securities Entitlements. See U.C.C. §8-102(17).

changed significantly from the prior version of Article 8. The primary change, however, is that while Parts 2, 3, and 4 of Article 8 only apply to securities, the new Part 5 is also applicable to a broader category called "financial assets."<sup>32</sup>

Another significant issue the drafters had to contend with was the imposition of certain obligations relating to the manner in which the securities intermediaries can deal with assets to which their entitlement holders have securities entitlements.<sup>33</sup> Succinctly, there are five primary

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ARK. CODE ANN. § 4-8-102(a)(15) (Michie Supp. 1995). It is important to note that ARK. CODE ANN. § 8-102(a)(15)(iii)(B) provides an "option" feature permitting an obligation or interest that is a medium for investment to be governed by Revised Article 8.

32. The term "financial asset" incorporates the definition of security and also includes: any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under this chapter. . . . [T]he term [includes] either the interest itself or the means by which a person's claim to it is evidenced, including a certificated or uncertificated security, a security certificate, or a security entitlement.

ARK. CODE ANN. § 4-8-102(a)(9)(iii) (Michie Supp. 1995). The term "financial asset" not only includes securities, but also other interests, obligations, or property that are held through the securities account, such as bonds and money market instruments. Since both terms naturally overlap, section 4-8-103 of the Arkansas Code considers some of the more common forms of investments and determines which forms are financial assets, securities, or neither. For example, a commodity contract is excluded from both definitions; however, commodity contracts are dealt with in a similar fashion under Article 9. See ARK. CODE ANN. §§ 4-8-103(f), 4-9-115 (Michie Supp. 1995). Consequently, you will find the drafters' term "investment property" to be a catch-all description which includes securities, securities entitlements, and commodity futures. See ARK. CODE ANN. § 4-9-115(1)(f) (Michie Supp. 1995).

33. See generally ARK. CODE ANN. §§ 4-8-501 to -511 (Michie Supp. 1995). A security entitlement arises on behalf of the holder "when a financial asset [is] credited to a 'securities account.'" U.C.C. § 8-501 cmt. 1 (1994). At this juncture, it's important to recognize that while Revised Article 8's new Part 5 describes the property interest created when a financial asset is credited to a person's securities account, it is carefully limited to describing the resulting "package of rights" with respect to that interest. Prefatory Note, at 17. Revised Article 8 is not intended to provide a comprehensive body of law governing the relationships between customers and their securities intermediary. *Id.* However, while Part 5 describes the rights held by the entitlement holder and the securities intermediary, it also serves to identify the risks imposed by acquiring a security entitlement from a securities intermediary. The degree of exposure depends on the solvency of the chosen intermediary. Although this relationship places a premium on the selection of an intermediary, other protections are also available. For example, most intermediaries are members of the Securities Investor Protection Corporation which is subject to the Securities Investor Protection Act of 1970 (SIPA). 15 U.S.C. §§ 78aaa-III (1994). SIPA provides protection of up to \$500,000, including a limit of \$100,000 for cash, against losses for each customer of an insolvent broker or dealer. *Id.* § 78fff-3(a)(1). In addition, most securities firms procure private insurance to cover potential losses. Furthermore, pervasive government regulation of the securities industry supplies additional customer protection. See Mooney, Jr., *An Introduction to the Revised U.C.C., Article 8*, *supra* note 2 at 1895. For another discussion of the

duties imposed on securities intermediaries by Part 5 of Revised Article 8. One of the core duties of a securities intermediary is to maintain sufficient financial assets to cover all entitlements created.<sup>34</sup> The purpose of this section is to recognize that, as conducted today, it is not possible to trace specific securities belonging to a specific customer.<sup>35</sup> In upholding this duty, a securities intermediary may maintain these financial assets either directly or indirectly through one or more securities intermediaries.<sup>36</sup> Finally, implicit in the obligation to maintain sufficient financial assets on behalf of the entitlement holder is the proscription against granting a security interest in the same financial asset unless authorized to do so by the customer.<sup>37</sup> A typical arrangement where customers will authorize the pledging of their security entitlements to another arises in the maintenance of a margin account with the securities intermediary. In order to secure the funds for a customer's margin account, a securities intermediary will obtain financing from a lender by granting a security interest in the customer's securities.<sup>38</sup> Although section 8-504 of the U.C.C. allows for these arrangements, the agreement between the customer and the securities intermediary must specify the extent to which the customer's securities may be pledged and the explicit consent of the customer is required.<sup>39</sup>

The second duty imposed upon a securities intermediary is to take appropriate action to ensure that an issuer's payment of distributions are received by the entitlement holder.<sup>40</sup> This remains true whether the payment may be distributed directly to the entitlement holder or paid to the securities intermediary.<sup>41</sup> The drafters recognized that one of the principal reasons

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regulatory regime which protects securities investors, see U.C.C. § 8-511, cmt. 2 (1994).

34. A securities intermediary must maintain a sufficient quantity of financial assets with which to cover the aggregate amount of all financial assets held on behalf of entitlement holders. ARK. CODE ANN. § 4-8-504(a) (Michie Supp. 1995).

35. In today's securities business, securities firms often hold securities in fungible form, and the manner in which they maintain their inventory of securities makes impractical the specific identification of a customer's particular security. U.C.C. § 8-504 cmt. 1 (1994). The inability to trace the ownership of particular securities is a direct result of the "clearance and settlement" process. Schroeder, *Article 8, supra* note 2, at 332-33.

36. ARK. CODE ANN. § 4-8-504(a) (Michie Supp. 1995). Financial assets may be held either directly in the form of a security certificate or indirectly by way of a security entitlement. U.C.C. § 8-504 cmt. 1 (1994) ("That point is implicit in the use of the term 'financial asset' . . .").

37. ARK. CODE ANN. § 4-8-504(b); see also U.C.C. 8-504 cmt. 2 (1994).

38. U.C.C. § 8-504 cmt. 2 (1994). The process of obtaining funds for a customer's margin account by granting a security interest to a lender is called "rehypothecation."

39. *Id.* Federal regulations also limit the amount of securities "to 110% of the aggregate amount of the borrowings of all customers." *Id.*

40. ARK. CODE ANN. § 4-8-505(a) (Michie Supp. 1995).

41. ARK. CODE ANN. § 4-8-505(b) (Michie Supp. 1995).

investors use securities intermediaries is to obtain the professional management of their investments while retaining the "economic benefit[s] of ownership."<sup>42</sup>

A third duty imposed by Part 5 ensures that not only the "economic benefits of ownership" pass through to the entitlement holder as in section 8-505 of the U.C.C. but other rights as well.<sup>43</sup> Section 8-506 of the U.C.C. recognizes the realities of the indirect holding system in which securities intermediaries holding securities through other intermediaries or clearing corporations are in a position to exercise the corporate rights of ownership because the issuer will not know the identity of the entitlement holder. However, section 8-506 requires the securities intermediary to act on behalf of its customers in accordance with an existing agreement, or in the absence of an agreement, by exercising due care in accordance with reasonable commercial standards or placing the customer in a position to exercise such rights directly.<sup>44</sup> Of course, section 8-506 provides significant latitude by way of agreement for the securities intermediary to act in a strict representative capacity or according to its own discretion.<sup>45</sup>

A fourth duty requires the securities intermediary to comply with entitlement orders wherein the securities intermediary is directed to make some disposition of the financial asset.<sup>46</sup> This duty is subject to a number of qualifications. Specifically, the "entitlement order" must be originated by an "appropriate person" and the securities intermediary is permitted a reasonable opportunity to find the order genuine and authoritative after which it is further afforded a reasonable opportunity to comply with the order.<sup>47</sup> The "appropriate person" will typically be the entitlement holder, the person "identified in the records of the securities intermediary as the person having a securities entitlement . . . ."<sup>48</sup> In the event an entitlement holder grants a security interest in its securities entitlements to a third-party

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42. U.C.C. § 8-505 cmt. 1 (1994).

43. ARK. CODE ANN. § 4-8-506 (Michie Supp. 1995).

44. U.C.C. § 8-506 cmt. 1 (1994).

45. U.C.C. § 8-506 cmt. 2 (1994).

46. ARK. CODE ANN. § 4-8-507 (Michie Supp. 1995). An entitlement order is a "notification communicated to a securities intermediary directing transfer or redemption of a financial asset to which the entitlement holder has a security entitlement." ARK. CODE ANN. § 4-8-102(a)(8) (Michie Supp. 1995). It is important to recognize that the entitlement order is simply the instruction to a securities intermediary to transfer securities entitlements held by the customer. Thus, the rules governing entitlement orders in Article 8 are limited and are not intended to cover the entire relationship between a customer and a broker including the actual contracts for the purchase or sale of securities. See U.C.C. § 8-507 cmt. 5 (1994).

47. ARK. CODE ANN. § 4-8-508 (Michie Supp. 1995).

48. ARK. CODE ANN. §§ 4-8-107(a)(3), -102(a)(7) (Michie Supp. 1995).

lender, the intermediary owes no duty to act at the direction of the secured party, unless the securities intermediary has entered into a "control agreement" in which it has agreed to act on entitlement orders originated by the secured party.<sup>49</sup> In this case, the third-party lender does not then become an "appropriate person" but an "authorized person."<sup>50</sup>

Furthermore, section 8-507 of the U.C.C. addresses the fact that a transfer of securities made pursuant to an "effective entitlement order" is different from an "entitlement order originated by an appropriate person."<sup>51</sup> An entitlement order is effective under section 8-107(b) of the U.C.C. if either of the following conditions are met: (1) it is made by the appropriate person; (2) it is made by a person who has power to act for the appropriate person under the law of agency;<sup>52</sup> or (3) the appropriate person has ratified the entitlement order, regardless of who initiated the order, or the appropriate person is precluded from denying its effectiveness.<sup>53</sup> Subsection (b) of section 8-507 imposes liability on the securities intermediary only for the transfer of securities "pursuant to an ineffective entitlement order;"<sup>54</sup> thus, the securities intermediary escapes liability for wrongful transfer when it acts on an entitlement order originated by the entitlement holder's agent.<sup>55</sup> Although the securities intermediary is not acting on an entitlement order originated by an "appropriate person," the securities intermediary is protected by section 8-107(b), with the risk of a fraudulent entitlement order properly allocated between the securities intermediary and the entitlement holder.<sup>56</sup>

The final core duty imposed upon securities intermediaries is the duty to change an entitlement holder's position to another form of security holding.<sup>57</sup> Section 8-508 of the U.C.C. specifies that a securities intermediary "shall act at the direction of an entitlement holder" to either change the entitlement into an available and eligible form or transfer the financial assets

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49. U.C.C. § 8-507 cmt. 3 (1994).

50. *Id.*

51. U.C.C. § 8-507 cmt. 4 (1994).

52. In the case of an uncertified security, this would include a secured party who obtains "control" by entering into a control agreement with the issuer specifying that the issuer will comply with an entitlement order originating from the secured party without further consent from the registered owner, or in the case of a security entitlement, enters into an identical control agreement with the securities intermediary displacing the entitlement holder. ARK. CODE ANN. §§ 4-8-107(b)(2), -106(c)(2), and -106(d)(2) (Michie Supp. 1995).

53. *Id.* § 4-8-107(b)(1)-(3).

54. *Id.* § 4-8-507(b).

55. U.C.C. § 8-507 cmt. 4 (1994).

56. *Id.*

57. ARK. CODE ANN. § 4-8-508 (Michie Supp. 1995).



to the entitlement holder's securities account with another intermediary.<sup>58</sup> Therefore, the entitlement holder may request that registered securities certificates be delivered to, and registered in, the name of the entitlement holder, that bearer certificates be delivered to the entitlement holder, or that uncertificated securities be registered in the entitlement holder's name.<sup>59</sup> This duty, however, is conditioned on whether the entitlement holder is eligible to hold the securities in a particular form.<sup>60</sup> The issuer determines eligibility.<sup>61</sup> For example, some securities are issued as "book-entry only" and are registered in the name of the depository.<sup>62</sup>

The duties imposed by Revised Article 8 are defined by the "agreement/due care" formula that pervades the new Part 5. Each section provides that the particular duty imposed is satisfied if "the securities intermediary acts . . . as agreed upon by the entitlement holder and the securities intermediary" with respect to that duty.<sup>63</sup> Thus, the agreement creates the standard of care for executing Part 5's statutorily imposed duties. However, in order for an agreement to serve as the agreed upon standard of care, it must specifically detail how the intermediary will perform the particular duty.<sup>64</sup> For example, the agreement between the entitlement holder and securities intermediary will not establish the standard for performing the section 8-504 duty to maintain financial assets, although it may set out a standard for performing the section 8-505 duty to obtain payments and distributions, unless the standard of performance is specifically detailed in the agreement.<sup>65</sup> The comments to the U.C.C. state that the general obligation of good faith in the performance or enforcement of contracts and duties also applies to the agreement.<sup>66</sup> Therefore, a securities intermediary may not simply disclaim a statutory duty imposed by Part 5 as it would be inconsistent with the duty to act in good faith.<sup>67</sup>

The second prong of the "agreement/due care" formula provides that in the absence of an agreement the statutory duty will be satisfied if the securities intermediary exercises due care in accordance with reasonable commercial standards.<sup>68</sup> The duty of care even extends to the securities

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58. *Id.*

59. U.C.C. § 8-508 cmt. 1 (1994).

60. *Id.*

61. *Id.*

62. *Id.*

63. ARK. CODE ANN. §§ 4-8-504(c)(1), -505(a)(1), -506(1), -507(a)(1), and -508(1) (Michie Supp. 1995).

64. U.C.C. § 8-504 cmt. 4 (1994).

65. *See Id.*

66. *Id.*

67. *Id.*

68. ARK. CODE ANN. §§ 4-8-504(c)(2), -505(a)(2), -506(2), -507(a)(2), and -508(2)

intermediary's choice of other intermediaries who may hold the financial assets.<sup>69</sup>

Overlaying all of these duties are the common laws of contract and agency, and the federal and state regulatory laws. Consequently, section 8-509(a) of the U.C.C. provides that compliance with another statute, regulation, or rule that describes the parameters of the same duty found in Article 8 satisfies the "agreement/due care" formula.<sup>70</sup> Consistent with their approach throughout Revised Article 8, the drafters reiterate that the duties set forth in sections 8-504 through 8-508 are merely intended to describe the new concept of a security entitlement. Thus, other statutes must detail how to perform these duties.

### III. PERFECTION OF SECURITY INTERESTS IN INVESTMENT PROPERTY

Perhaps the biggest improvement in Revised Article 8, from a practitioner's perspective, is the simplification of the rules governing attachment, perfection, and priority of security interests in investment property.<sup>71</sup> Gone are the nebulous concepts of "transfer" and "constructive possession" contained in old section 8-313 of the U.C.C.<sup>72</sup> Revised Article 8 returns the fundamental rules regarding attachment and perfection of security interests in securities back to Article 9.<sup>73</sup> The drafters sought to avoid disruption of the established scheme of Article 9 by placing *all* of the principal rules concerning security interests in investment property in section 9-115 of the U.C.C. and adding additional rules to govern corresponding issues for other forms of collateral.<sup>74</sup> The general rules, terms, and concepts of Revised Article 8, however, continue to apply to issues not addressed by amended section 9-115.<sup>75</sup>

In order to have a valid security interest in investment property, one must satisfy the three formal prerequisites of section 9-203 of the U.C.C.:

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(Michie Supp. 1995).

69. U.C.C. § 8-504 cmt. 4 (1994).

70. ARK. CODE ANN. § 4-8-509(a) (Michie Supp. 1995).

71. See *supra* note 3.

72. C995 ALI-ABA 643, pp. 11-14. "[A]lthough the draftsman obviously had no quarrel with actual, physical possession, the Official Notes damn the entire idea of constructive possession and propose to expel it from this area of the law." *Id.* at p. 21. For a well-reasoned criticism of the problems with old Article 8, see SCHROEDER, *Article 8, supra* note 2.

73. 2C U.L.A. Revised Article 8 (1994) Investment Securities, Prefatory Note, at 44 (Supp. 1996).

74. U.C.C. § 9-115 cmt. 1 (1994).

75. *Id.*

(1) value must be given;<sup>76</sup> (2) the debtor must have rights in the collateral;<sup>77</sup> and (3) the debtor must grant the secured party rights in the collateral.<sup>78</sup> These prerequisites have not changed from previous versions. The rules for perfecting such security interest, however, have changed considerably. Perfecting a security interest in investment property may occur in one of two ways: by filing a UCC-1 financing statement<sup>79</sup> or by control.<sup>80</sup>

Control is a new concept created by the drafters.<sup>81</sup> The concept of "control" was specifically created to replace the common law principles of possession and constructive possession that have resulted in so much uncertainty and confusion when applied to the indirect holding system.<sup>82</sup> The acid test to determine if a secured party has "control" is whether or not the secured party can sell the collateral without further consent or action by the debtor.<sup>83</sup> Amended Article 9 incorporates the definition of control found in section 8-106 of the U.C.C. for certificated securities,<sup>84</sup> uncertificated securities,<sup>85</sup> and security entitlements.<sup>86</sup>

The specific means of obtaining "control" depends on the way the financial asset is held at the time in question. For a certificated security in bearer form, possession gives the secured party control.<sup>87</sup> Similarly, delivery plus an endorsement to the purchaser in blank or registration of the certificate in the name of the secured party constitutes control over a certificated security in registered form.<sup>88</sup> Consequently, a secured party who merely takes possession of a certificated security in registered form without

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76. ARK. CODE ANN. § 4-9-203(1)(b) (Michie Supp. 1995).

77. *Id.* § 4-9-203(1)(c).

78. *Id.* § 4-9-203(1)(a).

79. In order to perfect by filing, the secured party must also have a written security agreement. *Id.*

80. *Id.* §§ 4-8-106, 4-9-115(e).

81. See *Id.* § 4-9-203(1)(a). If the collateral is investment property, a signed security agreement is not required if the secured party obtains control pursuant to an agreement with the debtor. *Id.* Note that possession is *not* a method of perfection, but rather, physical possession of a certificated security is merely a way of obtaining "control." *Id.*

82. U.C.C. § 8-106 cmt. 7 (1994).

83. *Id.*

84. See Figure 4 for a diagram of the methods for granting and perfecting a security interest in certificated securities.

85. See Figure 5 for a diagram of the methods for granting and perfecting a security interest in uncertificated securities.

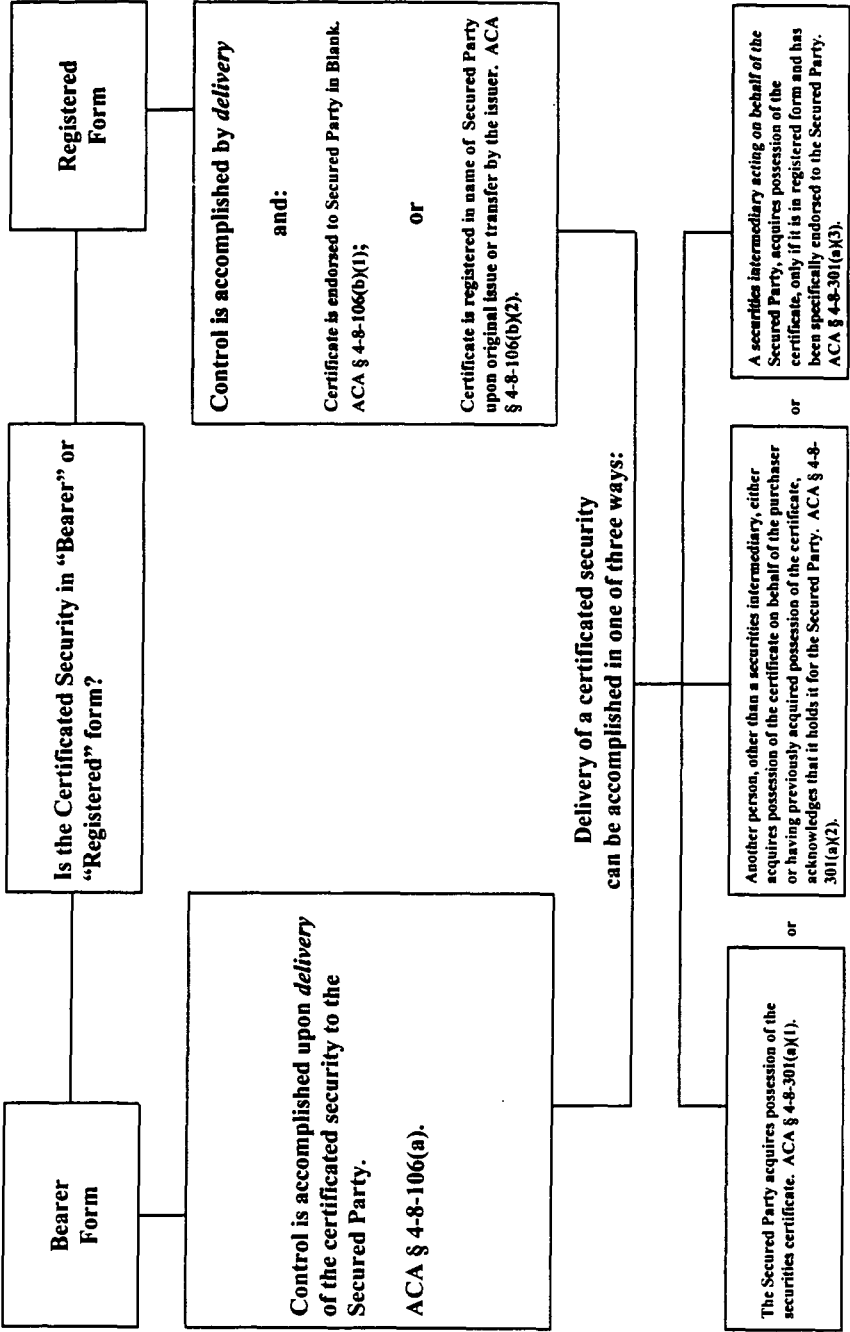
86. See Figure 6 for a diagram of the methods for granting and perfecting a security interest in security entitlements. See ARK. CODE ANN. § 4-9-115(1)(e) (Michie Supp. 1995). Section 4-9-115(1)(e) further defines "control" as the concept relates to commodity contracts and commodity accounts. See *id.*

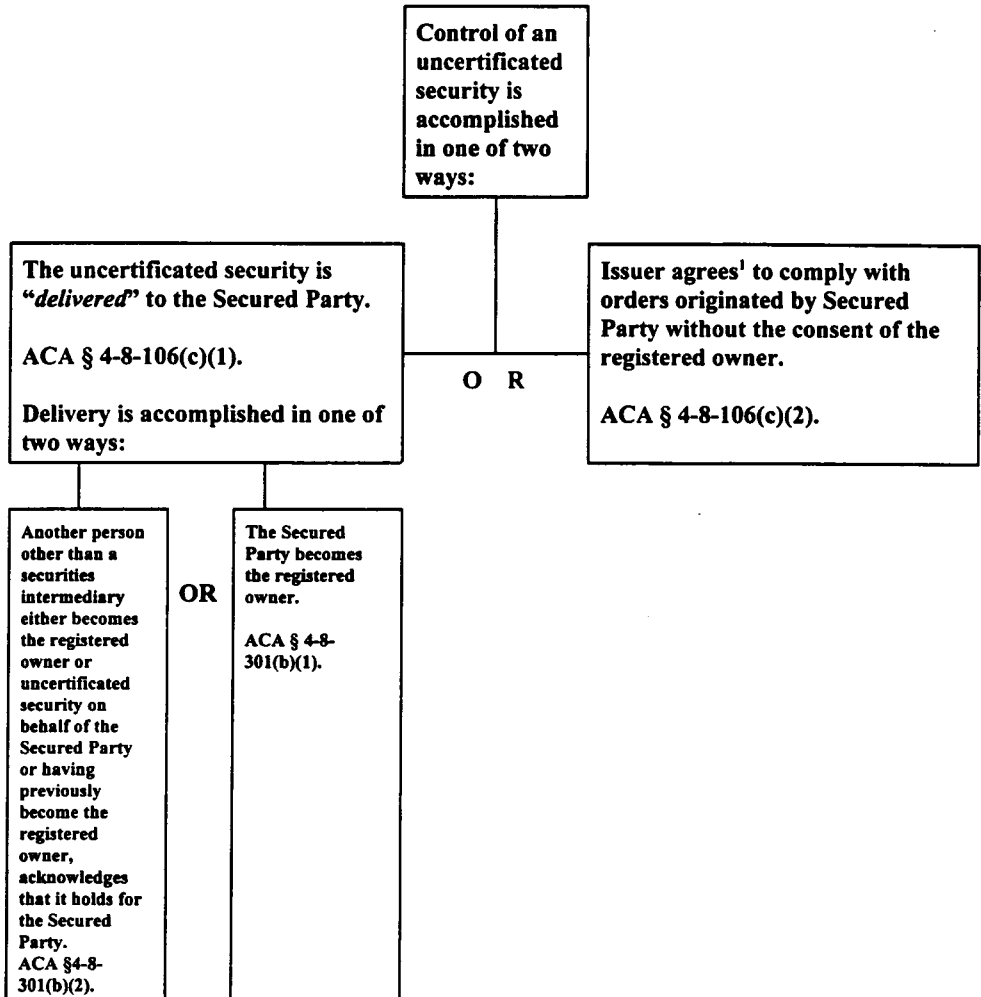
87. ARK. CODE ANN. § 4-8-106(a) (Michie Supp. 1995).

88. *Id.* § 4-8-106(b).

Methods of Obtaining Control of a Certificated Security

Figure 4

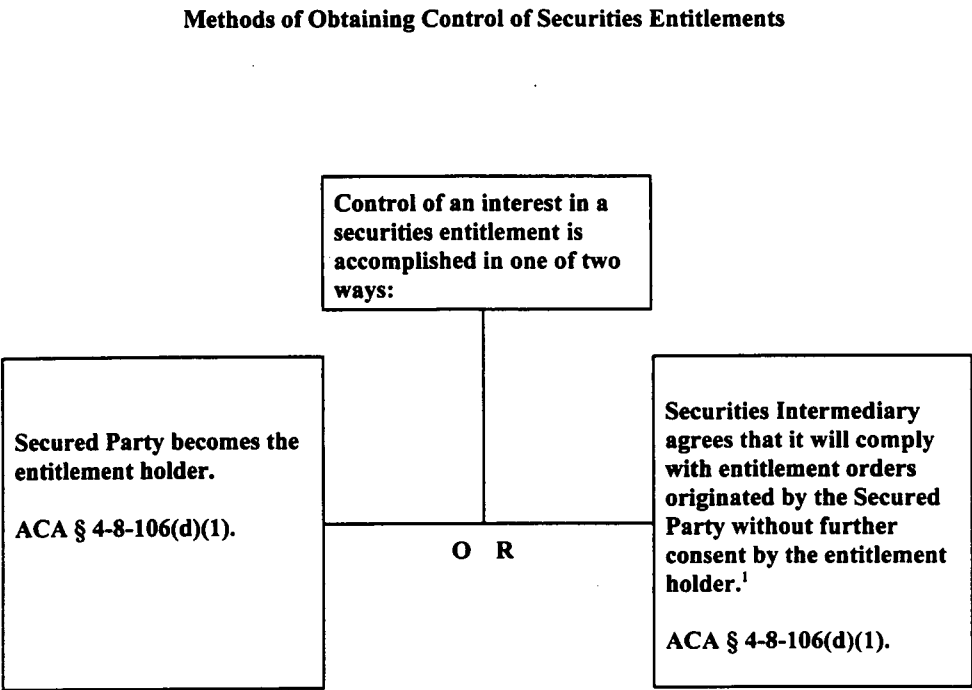


**Figure 5 - Methods of Obtaining Control of an Uncertificated Security**


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<sup>1</sup> Issuer may not enter into such an agreement without consent of the registered owner. Note, Issuer is not required to enter into such an agreement, even if the registered owner requests. ACA § 4-8-106(g).

Figure 6



<sup>1</sup> Note: Securities intermediary must obtain entitlement holder's consent, but securities intermediary is not required to enter into such an agreement, even if the entitlement holder requests. ACA §4-8-106(g).

taking the additional steps of having the certificate endorsed or registered does not have "control."<sup>89</sup>

There are two ways for a secured party to obtain a security interest in an uncertificated security. Under section 8-106(c)(1), a secured party will have control of an uncertificated security if it is "delivered to the purchaser."<sup>90</sup> Delivery of an uncertificated security is addressed in section 8-301(b) of the U.C.C. which provides that delivery occurs when the purchaser becomes a registered holder<sup>91</sup> or another person, *other* than a securities intermediary, either becomes the registered owner on behalf of secured party or acknowledges that it holds the uncertificated security for secured party.

The second way to obtain control of an uncertificated security is set forth in section 8-106(c)(2). Under this section, the secured party has control *if the issuer has agreed* to act on the instructions of the secured party without further consent of the registered owner.<sup>92</sup> This option permits the secured party to allow the owner to continue dealing with the securities as the listed owner while the security interest is maintained.<sup>93</sup> In this manner, the practice of offering a registered pledge as under the prior version of Article 8 is retained.<sup>94</sup>

Although Revised Article 8 allows a secured party to obtain control by an agreement with the issuer, the issuer is not *required* to recognize the assignment, even if the entitlement holder directs the securities intermediary to recognize the assignment.<sup>95</sup> In addition, in the event the issuer agrees to recognize the secured party's interest, it "is not *required* to confirm the existence of the agreement to another party unless requested to do so by the registered owner or entitlement holder."<sup>96</sup> This is in contrast to prior law

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89. *Id.* Although prior law did not contain the registration or endorsement of a certificated security requirement, it has been the custom in Arkansas to take such controlling steps in order to expedite the foreclosure process. *But see* ARK. CODE ANN. § 4-9-115(4)(b)-(c) although the endorsement is lacking, delivery of the certificate to the Secured Party is enough to attach and perfect the security interest. Such security interest has priority over conflicting security interests which are perfected by means other than control.

90. U.C.C. § 8-106(c)(1) (1994).

91. *Id.* § 8-301(b)(1) & (2).

92. ARK. CODE ANN. § 4-8-106(c)(2) (Michie Supp. 1995) applies only to securities held directly, that is, between the issuer and the debtor and *not* between a securities intermediary and a debtor. While the former desires to gain "control" of an uncertificated security, the latter seeks to obtain "control" of a security entitlement.

93. ARK. CODE ANN. § 4-8-106(f) (Michie Supp. 1995).

94. U.C.C. § 8-401(2) (1978).

95. ARK. CODE ANN. § 4-8-106(g) (Michie Supp. 1995).

96. *Id.* (emphasis added).

which required issuers to send transaction statements to registered owners and pledgees.<sup>97</sup>

It has been this author's experience that, when given the choice, issuers will take the path of least resistance and will not recognize transfer orders from persons other than the registered owners. Of course, one can envision certain instances, such as with closely-held corporations, limited partnerships, or similar issuers, where companies may be more likely to agree to register such pledges.<sup>98</sup>

The methods by which a secured party may obtain control of a securities entitlement are parallel to the methods used to obtain control of an uncertificated security. That is, the secured party may either: (a) become the entitlement holder,<sup>99</sup> or (b) obtain an agreement with the securities intermediary that the securities intermediary will comply with instructions of the secured party without further consent by the entitlement holder.<sup>100</sup>

It should be noted that the concept of control does not mean complete and absolute control. The comments to the U.C.C. state that "there is no requirement that the powers held by the purchaser be exclusive."<sup>101</sup> The secured party can allow the debtor to retain the right to make substitutions or to direct the disposition of the security entitlement, without losing "control" of its collateral.<sup>102</sup> Consequently, section 8-106(f) allows a secured party to share control of a securities entitlement with a debtor, thereby providing greater flexibility in the use of securities accounts as collateral while maintaining priority over other secured parties who do not have "control."<sup>103</sup> To some, such an arrangement invites debtor misconduct, but to others such an arrangement provides greater security. Professor

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97. U.C.C. § 8-408 (1990).

98. Schroeder, *Article 8, supra* note 2, at 387-88. Schroeder argues that "registered pledges" may be useful for limited partnerships to facilitate financing by treating the privately issued limited partnership as a security and thereby making available the "control" provisions of Amended Article 9 applicable in order to better protect the secured party's interest. Schroeder, *Article 8, supra* note 2, at 388. See also ARK. CODE ANN. § 4-8-106(g) (Michie Supp. 1995).

99. ARK. CODE ANN. § 4-8-106(d)(1) (Michie Supp. 1995). That is, have the securities intermediary show on its books that it is holding the securities entitlements for the Secured Party and *not* the entitlement holder.

100. *Id.* § 4-8-106(d)(2).

101. U.C.C. § 8-106 cmt. 7.

102. ARK. CODE ANN. § 4-8-106(f) (Michie Supp. 1995). See Schroeder, *Article 8, supra* note 2, at 387-88.

103. ARK. CODE ANN. § 4-8-106(f) reiterates the principle that control is determined by what power the purchaser has obtained and not whether the debtor has retained other powers. See also U.C.C. § 8-106 cmt. 7 (1994).



Schroeder analyzes the advantages and disadvantages of shared control as follows:

The disadvantage of this method, obviously, is that, by giving the debtor flexibility to deal in financial assets held through a securities account, the secured party loses some of its ability to protect itself from debtor misbehavior. This is, however, no different from the risk faced by any secured creditor who allows its debtor to retain "possession" and the power to deal in collateral (such as in a typical inventory security arrangement). Indeed, the position of a secured party perfecting a security interest in securities entitlements by "control" is somewhat better than the inventory financier who perfects by filing. This is because the agreement between the secured party and the securities intermediary could provide that the securities intermediary will obey disposition orders only if certain contractual conditions are met — *e.g.*, the intermediary shall not obey a debtor's instruction received after notice of default sent by a secured party. In other words, arrangements could be made with a securities intermediary which would provide policing functions for the secured party somewhat similar to those provided by a traditional field warehouse for ordinary goods.<sup>104</sup>

Because the agreement with the securities intermediary above must be consented to by the entitlement holder and is typically signed by the secured party, it is typically referred to as a tri-party control agreement. A simple example of a tri-party control agreement is shown in Exhibit 1.

Understandably, due to the variety of duties which may be placed on the securities intermediary<sup>105</sup> by the over-zealous lender's counsel, securities intermediaries are reluctant to sign tri-party control agreements. Revised Article 8 grants the securities intermediary discretion as to whether such an arrangement should be created.<sup>106</sup> Consequently, it remains to be seen under what terms intermediaries will agree to provide these services to debtors and secured parties.<sup>107</sup>

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104. Schroeder, *Article 8*, *supra* note 2, at 389.

105. Although these methods of control are designed primarily for the debtor/third-party lender relationship, a large majority of these transactions are margin loans from a broker (*i.e.*, securities intermediary) to its customer. Since the securities are more than likely already in the broker's name, the broker gains "control" of the security automatically upon the entitlement holder granting the broker a security interest. ARK. CODE ANN. § 4-8-106(e) (Michie Supp. 1995).

106. *See id.* § 4-8-106(g). A securities intermediary is not required to enter into such an agreement even if directed to do so by the entitlement holder. A securities intermediary also does not have to confirm the existence of the Agreement, unless requested to do so by the entitlement holder.

107. It has been this author's experience that brokerage firms are less likely to enter into these agreements and that banks holding securities in their custodial accounts tend to be more

Except for brokers and securities intermediaries, an alternate means of perfecting one's security interest in investment property is by filing a U.C.C.-1 financing statement under section 9-115(4)(b) of the Uniform Commercial Code. The ability to perfect a security interest in investment property by filing is new. Of course, filing the financing statements does not give the secured party "control" over the security (i.e., the ability to sell). Consequently, the ability to perfect by filing financing statements will give most lenders little comfort because a secured party who perfects merely by filing is subject to being primed by a secured party who perfected its interest by "control."<sup>108</sup> However, assuming that the Debtor was not a securities intermediary and neither secured party had "control" then the customary rules regarding "first in time-first in right" will apply.

#### IV. PRIORITIES

The concept of "control" directly determines a secured party's priority. The general rule is, the greater "control," the higher priority the security interest will have.<sup>109</sup> For example, the secured party who has obtained control over investment property will have priority over a secured party who merely files a financing statement to perfect its interest.<sup>110</sup> The priority rules for conflicting security interests in the same investment property are set out in Arkansas Code Annotated § 4-9-115(5).<sup>111</sup> These rules are somewhat complicated and in some instances contrary to the *customary* Article 9 priority rules.

For example, if two secured parties (neither of which are Securities Intermediaries) have control, then each secured party has a pro rata interest in such investment property.<sup>112</sup> Note that the first in time, first in right rules

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agreeable. One point to look out for, especially in active accounts, is the costs involved in registering and entering into this type of agreement. One should also pay particular attention to the fees, if any, which will be charged to provide this service. This author has found, by experience, that the fees are sometimes charged on individual transactions in and out of these securities accounts, which, depending on the activity in the account, can be quite expensive.

108. See *infra* Part III (discussing the various methods for obtaining control). The probable effect of the ability to perfect by filing will be that belt and suspenders lenders and their legal counsel will include the new terms like "financial assets" and "investment property" to their boilerplate descriptions of the Debtor's collateral, but when they are seriously looking to such collateral, they will demand a tri-party control agreement.

109. U.C.C. § 9-115(5) (1994).

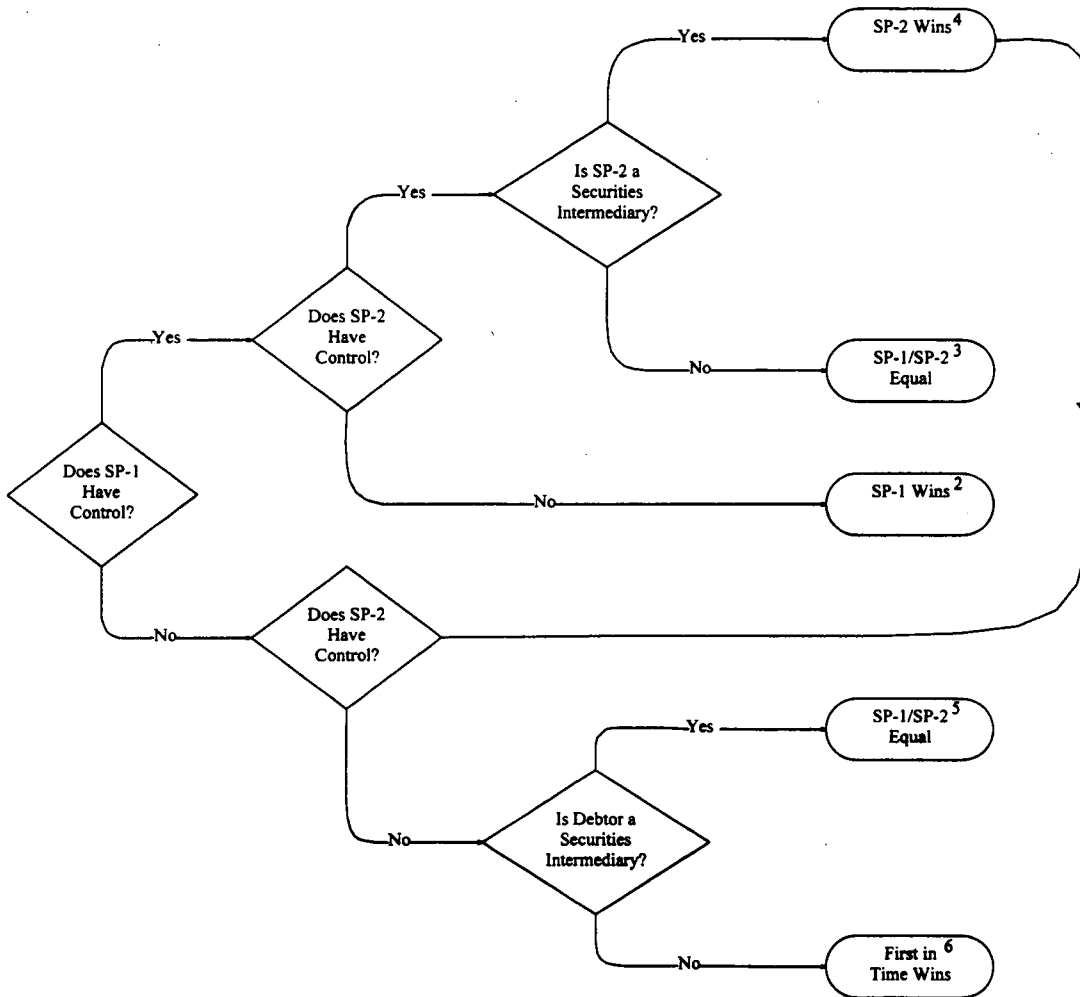
110. See ARK. CODE ANN. § 4-9-115(5)(a) (Michie Supp. 1995). See also, *Super-Priority of Securities Intermediaries Under New Section 9-115(5)(c) of the Uniform Commercial Code*, 108 HARV. L. REV. (1995).

111. See Figure 7 for a diagram of the priority rules.

112. See ARK. CODE ANN. § 4-9-115(5)(b) (Michie Supp. 1995).

Figure 7

**PRIORITY OF SECURITY INTERESTS  
IN INVESTMENT PROPERTY<sup>1</sup>**



1. This diagram is reprinted with the permission of the American Bar Association.

2. See ARK. CODE ANN. § 4-8-115(a).

3. See ARK. CODE ANN. § 4-8-115(b).

4. See ARK. CODE ANN. § 4-8-115(c).

5. See ARK. CODE ANN. § 4-8-115(e).

6. See ARK. CODE ANN. § 4-8-115(f).

do not apply. This means that Mr. Street could theoretically pledge his 200 shares of Leap of Faith Bungee Company stock to Lender No. 1 and then the next week, pledge the same shares to Lender No. 2. Upon default, Lender No. 1 and Lender No. 2 would each have a pro rata interest in the stock, despite the fact that Lender No. 2 perfected its security interest *after* Lender No. 1.

The results will vary depending on whether the Secured Party or Debtor is a Securities Intermediary. Suppose, for example, that Lender No. 2 was also Mr. Street's Securities Intermediary. Lender No. 2's security interest (even though "perfected" later in time) will prime Lender No. 1's security interest,<sup>113</sup> unless Lender No. 2 expressly agreed with Lender No. 1 that Lender No. 1's security interest would have priority.<sup>114</sup> Because of this possibility, the well-drafted Tri-Party Control Agreement should contain a waiver of the right to any security interest and a prohibition against the intermediary and debtor further pledging the investment property.

Finally, suppose the "Debtor" is Mr. Street's Securities Intermediary, Big Bull Brokerage. Big Bull Brokerage obtains loans from Secured Party 1 and Secured Party 2 and secures the loans with certain securities identified on lists provided to Lender on a daily basis. Both Secured Party 1 and Secured Party 2 have perfected security interests under the automatic perfection rule in Arkansas Code Annotated § 4-9-115(c).<sup>115</sup> Because "conflicting security interests granted by a broker, a securities intermediary or a commodity intermediary which are perfected without control rank equally," each secured party will share pro rata.<sup>116</sup>

## V. CHOICE OF LAW

The development of the indirect holding system and the subsequent creation of the securities entitlement concept presented the drafters with unique opportunities to further muddy the waters with respect to issues pertaining to the already chocolate waters of the indirect holding system. However, the drafters have attempted to clarify the rules to ensure that a securities intermediary and all of its entitlement holders can look to a "single, readily identifiable body of law to determine their rights and duties."<sup>117</sup> Section 8-110(b) of the U.C.C. states that the local law of the

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113. *Id.*

114. See ARK. CODE ANN. § 4-9-115(5)(c) (Michie Supp. 1995).

115. See Example 6 of Comments to Article 9 (Hawland 27 of the conforming and miscellaneous amendments).

116. See ARK. CODE ANN. § 4-9-116(5)(e) (Michie Supp. 1995).

117. U.C.C. § 8-110 cmt. 3 (1994).

securities intermediary's jurisdiction, as specified in subsection (e), governs the issues concerning the indirect holding system addressed in Article 8. Section 8-110(e) sets out a series of tests to identify the securities intermediary's jurisdiction. Subparagraph (1) allows the securities intermediary and its entitlement holder to agree that the law of a particular jurisdiction will govern.<sup>118</sup> Subparagraph (2) states that in the event the securities intermediary and entitlement holder do not specify a governing law but expressly specify that the securities account is maintained at an office in a particular jurisdiction, the law of that jurisdiction will govern.<sup>119</sup>

In the event the securities intermediary and entitlement holder do not provide for a jurisdiction or specify where the securities account is to be maintained, the jurisdiction will be the office identified in the account statement servicing the entitlement holder's account.<sup>120</sup> If the account statement does not identify the office servicing the entitlement holder's account, then by default, the securities intermediary's jurisdiction is the jurisdiction in which the chief executive office of the securities intermediary is located.<sup>121</sup>

## VI. CONCLUSION

Revised Article 8 is a tremendous improvement over the prior versions. The drafters of revised Article 8 have, to the extent reasonably possible, simplified the law governing attachment and perfection of security interests in investment property. The drafters have attempted to craft a neutral framework which should allow for some flexibility as technology and usage inevitably demand further changes to current securities holding practices. While Revised Article 8 is by no means perfect, and certain provisions will undoubtedly be litigated in the future,<sup>122</sup> on balance, these potential problems certainly do not outweigh the advantages. Principally, the simplification and clarity gained by the entire securities industry, and in particular, lenders and their counsel attempting to perfect security interests in investment property.

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118. *Id.* § 8-110(e)(1).

119. *Id.* § 8-110(e)(2). Official Comment 3 states that "[b]ecause the policy of this section is to enable parties to determine, in advance with certainty, what law will apply to transactions governed by this Article, the validation of selection of governing law by agreement is not conditioned upon a determination that the jurisdiction whose law is chosen bear a 'reasonable relation' to the transaction." *Id.*

120. *Id.* § 8-110(e)(3).

121. *Id.* § 8-110(e)(4).

122. *See, for example*, REVISED ARTICLE 8 AND THE AGREEMENT TO PLEDGE; SUPER-PRIORITY OF SECURITIES, ULC LAW JOURNAL, Vol. 28, No. 2, Fall, 1995.

**EXHIBIT 1****TRI-PARTY CONTROL AGREEMENT  
("Agreement")**

[Date]

[Name and Address of  
Securities Intermediary]

Attention:

Re: Notice of pledge of securities and securities accounts ("Collateral") described on the attached **Exhibit A** (the "Pledge") by [insert Debtor's name] ("Debtor") to [insert name of Securities Intermediary] ("Secured Party")

Dear Ladies and Gentlemen:

The Debtor has granted<sup>1</sup> to Secured Party a security interest in all securities and financial assets, and all investments, securities, cash money and other property credited thereto or deposited therein ("Collateral") which are held in [each of] the securities account(s) listed on the **Exhibit A** attached hereto (the "Securities Account") to secure indebtedness owing to Secured Party. Securities Intermediary represents and warrants to Secured Party that (a) the Securities Account Statement attached hereto is a complete and accurate statement of the Securities Account and the Collateral and all of such Collateral has been endorsed to Securities Intermediary or in blank,<sup>2</sup> (b) the Securities Account and the rights of Debtor in the account are valid and legally binding obligations of the Securities Intermediary and (c) on the date hereof, Securities Intermediary does not know of any claim to or prior security interest in the Securities Account other than the interest of Debtor and Secured Party.<sup>3</sup>

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<sup>1</sup> Note that it is not *required* that the Security Agreement be written (*see* ACA § 9-203(1)(a)), nor is the Securities Intermediary required to be a party to the Security Agreement.

<sup>2</sup> Unless the collateral has been endorsed to the Securities Intermediary or in blank, such collateral would not be considered a "securities entitlement." *See* ACA § 4-8-501(d).

<sup>3</sup> It is possible to grant multiple security interests in the Securities Account. Such competing interests in Securities Accounts will be divided pro rata. *See* ACA § 4-9-115(5)(b).

Tri-Party Control Agreement  
dated \_\_\_\_\_, 1996  
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Debtor irrevocably directs Securities Intermediary to make all notations in Securities Intermediary's records pertaining to the Securities Account that are necessary or appropriate to reflect the above Pledge. Securities Intermediary will change the styling of the Securities Account to read: "[Name of Secured Party] - Collateral Account - for \_\_\_\_\_ [name of Debtor]".

Debtor irrevocably instructs Securities Intermediary to follow only instructions received from the Secured Party, furnished in writing, without further consent of Debtor concerning:<sup>4</sup> (1) the payment or reinvestment of dividends or distributions; and (2) the redemption, transfer, sale or any other disposition or transaction concerning the Collateral or the income and principal proceeds, substitutions and reinvestment hereon, without the prior written consent of Debtor. However, Debtor may receive all income, including dividends and interest (but not stock splits, stock dividends, cash equity distributions, liquidating distributions, or other non cash principal disbursements) ("Income"); and with prior consent of Secured Party,<sup>5</sup> Debtor may originate trading instructions to the Securities Intermediary to make substitutions for and additions to the Collateral, all of which are Collateral to be held in the Securities Account subject to the Pledge in favor of the Secured Party<sup>6</sup>. No withdrawal of Collateral from the Securities Account by Debtor will be permitted under any circumstances, except for the purpose of allowing Debtor to receive the Income from the Securities Account and/or substitution new Collateral of equal or greater value, without the prior written consent of Secured Party. Any additional securities delivered to the Securities Account will be subject to the Pledge, without the necessity for any further documentation. Any such rights granted to Debtor may be revoked in writing at any time solely by Secured Party.

Debtor also irrevocably authorizes and directs Securities Intermediary to send all notices, statements and all other communications concerning the Collateral or the Securities Account to the following address or such other address as may be specified in written instructions from Secured Party:

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<sup>4</sup> This language satisfies the crucial element of control. See ACA § 4-9-115(4) and § 4-8-106(2).

<sup>5</sup> Most agreements require the Secured Party to approve any trades, however, this is usually a hotly contested provision since delays in obtaining the Secured Party's approval can affect the Debtor's ability to sell the security at its target price.

<sup>6</sup> Some Secured Parties do not give the Debtor this many rights, however, such rights do not affect perfection or priority. See ACA § 4-8-106(d)(2).

Tri-Party Control Agreement  
dated \_\_\_\_\_, 1996  
Page 3

[Insert Name and Address of the Secured Party]

Telephone:

Fax:

Secured Party may exercise its rights under the Pledge or other loan documents or hereunder with respect to the Securities Account without any further consent of Debtor. Securities Intermediary is directed to follow all of Secured Party's instructions without investigating the reason for any action taken by the Secured Party or the existence of any default. Secured Party's signature alone will be sufficient authority for the exercise of any rights by Secured Party and a receipt from Secured Party alone will be a full release and discharge for Securities Intermediary. Checks for all or any part of the Collateral will be payable to the order of Secured Party if, when and in such amounts as may be requested by Secured Party.

Neither Securities Intermediary nor any of its respective partners, trustees, officers, employees or affiliates will be liable for complying in good faith with the instructions contained in this Agreement or failing to comply with any contrary or inconsistent instructions that may be subsequently issued by the Debtor. The Debtor further holds harmless and indemnifies each of them against any claim, loss, cost or expense arising out of any actions or omissions taken by any person in reliance on or compliance with the instructions and authorizations contained in this Agreement. The instructions contained in this Agreement may be revoked and the terms of this Agreement may be amended by Debtor only upon the receipt by Securities Intermediary of Secured Party's written consent to such revocation or amendment, or written notification to Securities Intermediary from Secured Party that the Pledge has been terminated. The rights and powers granted herein to Secured Party have been granted in order to perfect its security interest in the Securities Account, are powers coupled with an interest and will neither be affected by the death or bankruptcy of Debtor nor by the lapse of time.

Securities Intermediary agrees to hold the Collateral, the Securities Account and all of the contents including any free credit balances for and on behalf of the Secured Party and as bailee in possession for Secured Party.

All items of income including dividends, interest and other income, gain, expense and loss recognized in the Securities Account shall be reported by Securities Intermediary in the name and tax identification number of Debtor.



Tri-Party Control Agreement  
dated \_\_\_\_\_, 1996  
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The terms of this Agreement shall be binding upon, and shall inure to the benefit of, the parties hereto and their respective successors or, if applicable, heirs and personal representatives. The parties hereto agree that certain material events, occurrences and transactions relating to this Agreement bear a reasonable relationship to the State of Arkansas. The validity, terms, performance and enforcement of this Agreement shall be governed by those laws of the State of Arkansas which are applicable to agreements which are negotiated, executed, delivered and performed solely in the State of Arkansas.

**This written agreement represents the final agreement between the parties and may not be contradicted by evidence of prior, contemporaneous, or subsequent oral agreements of the parties.**

**There are no unwritten oral agreements between the parties.**

Very truly yours,

[Name of Debtor]

Date: \_\_\_\_\_, 199

By:  
Name:  
Title:

Address:

Fax:

**SECURED PARTY**

[Name of Secured Party]

Date: \_\_\_\_\_, 199

By:  
Name:  
Title:

**Receipt, Acknowledgment and Waiver of Lien**

Securities Intermediary acknowledges receipt of the Pledge, consents to the terms thereof and agrees to be bound by the terms of the foregoing Agreement and will hold the Securities

Tri-Party Control Agreement  
dated \_\_\_\_\_, 1996  
Page 5

Account on behalf of Secured Party as bailee. Securities Intermediary (i) certifies that **Exhibit A** attached hereto is a complete and correct list of the securities and financial assets contained in the Securities Account as of the date hereof; (ii) certifies that it has not received any notice regarding any lien, encumbrances or other rights to the Collateral from any other person; (iii) waives, releases and agrees not to assert any liens, encumbrances, claim or rights of set-off it may have against the Securities Account or any Collateral carried in the Securities Account;<sup>7</sup> (iv) will not agree with any third party that Securities Intermediary will comply with orders or instructions concerning the Securities Account by such third party without the prior written consent of Secured Party;<sup>8</sup> (v) agrees that it will promptly (at least within three Business Days) give Secured Party notice of any adverse claim of any person other than Secured Party with respect to the Securities Account or any Collateral carried in the Securities Account; (vi) in the event of a conflict between the foregoing agreement and any other agreement between the Securities Intermediary and the Debtor, the terms of this agreement will prevail; and (vii) regardless of any provision in such other agreements, the State of Arkansas shall be deemed the Securities Intermediary's location for the purposes of the foregoing agreement and the perfection and priority of Secured Party's security interest in the Securities Account.<sup>9</sup>

ACCEPTED AND AGREED TO BY  
SECURITIES INTERMEDIARY:

[Name of the Securities Intermediary]

Date: \_\_\_\_\_, 199

By:  
Name:  
Title:

Address:

Fax:

[Acknowledgments Follow.]

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<sup>7</sup> Without this waiver, ACA § 4-9-115(5)(c) gives the Securities Intermediary a priority over the Secured Party.

<sup>8</sup> See ACA § 4-9-115(5)(b).

<sup>9</sup> This is necessary to establish the Securities Intermediary's jurisdiction under ACA § 4-8-110(b).

**EXHIBIT A**  
**TO TRI-PARTY AGREEMENT**

[Description of Pledged Securities and/or Securities Accounts]

Securities Account Number/Title

Name and Address of Securities Intermediary

Account No.

Style of Account:

ATTN:

As more specifically set forth on the attached Account Statement, as such Securities Accounts exist on the date hereof and as such Securities Accounts may be constituted in the future and in all of the following:

- (a) any free credit balance or other money, now or hereafter credited to, or owing from Securities Intermediary to Debtor in respect of, the Securities Account;
- (b) any money, securities (certificated or uncertificated), securities entitlements, commodities contracts, instruments, documents, general intangibles, financial assets or other investment property distributed from the Securities Account, now or in the future;
- (c) all books and records relating thereto;
- (d) all proceeds of the sale, exchange, redemption or exercise of any of the foregoing thereof including but not limited to, any of the foregoing thereof, including but not limited to any dividend, interest payment or other distribution of cash or property or otherwise in respect thereof; and
- (e) any rights incidental to the ownership of any of the foregoing, such as voting, conversion, subscription and registration rights and rights of recovery for violations of applicable securities laws.